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No. 76-1120

In the Supreme Court of the United States

OCTOBER TERM, 1976

STATE OF CALIFORNIA DEPARTMENT OF BENEFIT PAYMENTS, ET AL., PETITIONERS

v.

JOHN M. ENGLAND, TRUSTEE IN BANKRUPTCY IN THE MATTER OF SHAKESTEERS COFFEE SHOPS, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

WADE H. McCREE, JR.,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

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The question presented in this bankruptcy case is whether amounts paid by a debtor in possession in a Chapter XI arrangement proceeding into a special account for federal withholding, employment (F.I.C.A.), and California taxes, pursuant to 26 U.S.C. 7501(a) and an order of the arrangement court, are a trust fund in favor of the United States and the State of California; or whether, as the court of appeals held, such amounts become a general asset of the bankrupt estate and subject to the claims of all creditors when the debtor is subsequently adjudicated a bankrupt.

The pertinent facts are not disputed. In January 1971, the debtor Shakesteers Coffee Shops petitioned for an

arrangement under Chapter XI of the Bankruptcy Act (as added, 52 Stat. 905, and amended, 11 U.S.C. 701 *et seq.*). The arrangement court thereafter entered an order for payment of state and federal taxes and directed the debtor to segregate from all other funds the taxes accruing on its business operations. The court required the debtor to open a special tax account and make regular deposits of the withholding taxes due on the wages paid to its employees. Pursuant to the court's order, the debtor deposited approximately $9,000 in the account for withholding taxes, employment (F.I.C.A.) taxes, and certain California unemployment, disability, and sales taxes. Withdrawals from the account were allowed only with joint signatures of the debtor and the arrangement court (Pet. App. A, p. 2).

An arrangement was neither proposed nor confirmed and in March 1971 the debtor was adjudicated a bankrupt. At that time, the funds in the special tax account were paid over to the trustee in bankruptcy and placed in his trustee account. In February 1974, the trustee applied for instructions from the bankruptcy court as to the disposition of the proceeds of the special tax account because he was concerned that if the balance in that account was paid to the United States and the State of California, there would be insufficient funds to pay the costs and expenses of administration. After a hearing, the bankruptcy court ruled that the special-tax account was a trust fund in favor of the federal government and the State of California (Pet. App. D).

On appeal by the trustee, the district court reversed. It held that the special tax account was a general asset of the bankrupt's estate to the extent necessary to pay expenses of administration (Pet. App. C). The court of appeals affirmed (Pet. App. A). It rejected the federal

government's argument that the withheld taxes constituted a trust in favor of the United States, pursuant to 26 U.S.C. 7501(a). Relying on *United States* v. *Randall*, 401 U.S. 513, the court of appeals concluded that the first priority accorded costs and administrative expenses by Section 64a(1) of the Bankruptcy Act (30 Stat. 563, as amended, 11 U.S.C. 104(a)(1)) was an "overriding statement of federal policy on [the] question of priorities" (Pet. App. A, p. 3, quoting from *United States* v. *Randall, supra*, 401 U.S. at 515).

1. We agree with the State of California that the decision of the court of appeals represents an erroneous application of *United States* v. *Randall, supra*. In that case, the debtor corporation, kept in possession of its business by court order under Chapter XI of the Bankruptcy Act, did not comply with requirements that it deposit withheld taxes in a special tax account. It was later adjudicated a bankrupt and the United States asked the bankruptcy court to pay the amount of withheld taxes prior to payment of costs and expenses of the bankruptcy proceedings. The government relied upon 26 U.S.C. 7501(a), which provides that the amount of withheld taxes "shall be held to be a special fund in trust for the United States." In rejecting the government's argument that the withheld taxes were a trust in favor of the United States, the Court observed "that the debtor-in-possession failed to segregate the taxes so withheld; hence there was no trust" (401 U.S. at 515). That was the basis for the decision in *Randall*, for the trustee "concede[d] that if the order had been obeyed, [he] would have [had] no case. Tr. of Oral Arg. 34" (401 U.S. at 518, Blackmun, J., dissenting). Unlike the facts in *Randall*, the trustee in this case obeyed the bankruptcy court's order to establish a trust fund for taxes. Thus, the rule of *Randall*

is inapplicable here, and therefore the trust fund should not have been merged into the bankrupt's general estate. See *Otte* v. *United States*, 419 U.S. 43, 57-58.

2. Although we agree with the State of California that the court of appeals has misconstrued and improperly extended this Court's decision in *Randall*, this case is the first appellate decision on the question whether a trust fund for taxes established by the trustee pursuant to court order in a Chapter XI proceeding will be upheld when the debtor is adjudicated a bankrupt. If the decision below were followed by the other courts of appeals, we believe it would present serious problems for the Internal Revenue Service and the state taxing authorities in proceedings under the Bankruptcy Act, where the trustee has either withheld or collected taxes. However, we cannot say that the impact of the decision of the court of appeals upon the collection of the federal revenue is sufficiently substantial to warrant this Court's review at present. For that reason, it is respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.,
Solicitor General.

APRIL 1977.

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